Share and Share Alike

Much commentary and public concern have focused on the evident trend decline in the share of U.S. national income flowing to labor (and the corresponding trend rise in the share of U.S. national income flowing to capital). It seems timely to review the data on labor’s share of national income in the U.S. economy historically – both the well-documented downward trend as well as the less-appreciated regular cyclical upswings in previous economic expansions. While it is too soon to tell if the current expansion will – like prior expansions – feature a rise in labor’s share back toward the historical average, there is some evidence of an acceleration in wages that is beginning to emerge in tandem with the ongoing decline in the unemployment rate. If and when labor’s share of national income and wages rises and unemployment continues to fall, what will be the implications for inflation and, in turn, the Fed?

Facts are Stubborn Things

Labor compensation as a share of national income fell sharply in 2009–2010 and has remained depressed since then (see Figure 1). Indeed, labor’s 0.65 share of national income at the end of 2013 was the smallest slice of national income paid to labor in at least 60 years!
While there has been justifiable focus on the downward trend in labor’s share, the chart also makes clear that in past business cycle expansions, there has also been a pronounced cyclicity in labor’s share of national income. In the three expansions during the “Great Moderation” – the quarter century after Paul Volcker broke the back of inflation – labor’s share of income initially fell during the early dates of recovery and then began to rebound during the expansion phase of the business cycle. Importantly, this rise in labor’s share occurred before, and usually well before, the business cycle peak and continued as the economy fell into recession. The rise in labor’s share that occurs during recessions is well known and is usually attributed to the desire of firms to “hoard” labor initially in downturns as sales decline – holding off on firing workers until the decline in demand is clearly expected to persist. What is less well appreciated is the phenomenon of labor’s rising share of income well in advance of the peak in economic activity and for reasons unrelated to labor hoarding.

### Labor’s share and inflation

If the past is prologue with regard to labor’s share and, as in past cycles, it does begin to rise as unemployment falls toward the nonaccelerating inflation rate of unemployment (NAIRU), what are the possible inflationary consequences? Interestingly, during the last three U.S. business cycles, the rise in labor’s share that commenced during the expansion phase of the business cycle was not accompanied by a material rise in PCE inflation (see Figure 2).

### TABLE 1

<table>
<thead>
<tr>
<th>Date of labor’s share bottom</th>
<th>Labor’s share of income at bottom (%)</th>
<th>Inflation at labor’s share bottom (%)</th>
<th>Date of labor’s share top</th>
<th>Labor’s share of income at top (%)</th>
<th>Inflation at labor’s share top (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984 Q2</td>
<td>0.68</td>
<td>4.4%</td>
<td>1992 Q3</td>
<td>0.71</td>
<td>2.6%</td>
</tr>
<tr>
<td>1997 Q3</td>
<td>0.68</td>
<td>1.6%</td>
<td>2001 Q1</td>
<td>0.71</td>
<td>1.8%</td>
</tr>
<tr>
<td>2006 Q3</td>
<td>0.67</td>
<td>2.1%</td>
<td>2008 Q4</td>
<td>0.70</td>
<td>1.4%</td>
</tr>
</tbody>
</table>
The contemporaneous relationship between changes in inflation and increases in labor’s share was negative in two of the last three business cycles – inflation fell as labor’s share of income rose – and essentially flat in the 1997–2001 episode. So, at least since Volcker, there has been no automatic or mechanical pass-through from a rise in labor’s share of the pie to PCE inflation. As it did during the Great Moderation, any pass-through, when and if labor’s share rebounds in this cycle, will depend on three factors: productivity growth, pricing power and the policy rate set by the Fed.

All eyes on the three Ps

The markets will be following closely how labor productivity and company pricing power evolve in tandem with compensation costs in coming quarters. The most favorable scenario for workers? Labor’s share of income rises in tandem with a combination of stronger productivity growth and, perhaps, some profit margin compression to produce a “goldilocks” outcome – a boost in the purchasing power of real wages without an unwanted surge in inflation significantly above the Fed’s 2% target. On the other hand, an unfavorable scenario for all concerned would be a rise in labor’s share accompanied by a productivity slowdown and aggressive efforts by companies to maintain existing profit margins at or near record peaks as a share of national income. In this case, the economy could face at least a whiff of stagflation. During the late 1960s and the 1970s, as inflation and inflation expectations began to rise, increases in labor’s share were largely passed through to headline inflation, in stark contrast to the post-Volcker track record. In fact, the all-time peak in labor’s share of income, 0.7127, was recorded during the 1980 recession, when PCE inflation exceeded 10%.

No one – certainly not this author – is predicting a return of labor market clout with the bargaining power to fuel double-digit inflation. But even with a modest increase in inflation from current levels, the Fed could face a situation in which real wage gains and falling unemployment – both welcome – occur in tandem with a rise in inflation above the 2% target. That said, Fed officials have emphasized that 2% is an inflation target, not a ceiling, and that inflation has, in fact, been running below 2% since 2012.

Thus far in the recovery from the Great Recession, the Fed has not faced a tradeoff between achieving its dual mandate objectives. Unemployment has been too high and inflation has been too low. Those days may well be coming to a close, and if so, the Fed will need to provide more guidance than it has so far about the “balanced approach” it says it plans to follow as it normalizes policy rates.